Volume 1, Section 3 – Finance

Q. (Section 3.3.3, The Automatic Adjustment Formula)

a. Please explain (i) how the Company proposes to establish the average cost of debt and the average cost of preference shares for the 2008 test year and (ii) how the Company proposes that these debt and preference share cost components of the weighted average cost of capital (WACC) be established within the automatic adjustment mechanism (AAM) for the years subsequent to 2008 when the AAM is in operation?

b. How likely is it that the embedded cost of debt (ECD) and the embedded cost of preference shares (ECPS) used in the AAM for years subsequent to 2008, that the Company proposes to establish as result of the accepted corresponding 2008 test year values, will vary significantly from the actual average costs of debt and preference shares that the Company experiences in these post-2008 years? Please identify and explain all of the possible sources/causes of variation and discuss the significance of their possible impact.

A. (a) The 2008 forecast average costs of debt and preferred shares are provided in Exhibit 10 of the Company's Application.

The average cost of preference shares for the 2008 test year is determined by dividing preferred dividends in 2008 by the average preferred shares.

Table 1 shows the calculation of the cost of debt included in the WACC under both the existing and proposed methods.

Table 1
2008 Cost of Debt – Existing versus Proposed
($000s)

	2008 Existing	**2008 Proposed**
Interest on long-term debt	31,513	31,513
Interest on short-term debt	2,563	2,040
Amortization of deferred debt issue costs	188	188
	34,264	33,741
Less:		
Interest on customer deposits[1]	(30)	-
Interest earned[2]	(1,200)	-
Interest cost for WACC	33,034	33,741
Average debt[3]	450,632	438,842
Cost of debt included in WACC	7.33%	7.69%

Other than adopting the *Consensus Forecasts* based approach of determining the annual change in the risk free rate in the calculation of the cost of equity, the Company is not proposing any changes to the treatment of the cost of debt or the cost of preferred shares for use in the automatic adjustment formula. The cost of debt and cost of preferred shares established for the 2008 test year are proposed to be used in the Formula over its period of operation.

[1] Under ARBM, interest on customer deposits is a component of the revenue requirement calculation but is not included in the calculation of WACC.

[2] Interest revenue is classified as a component of other revenue under ARBM. Currently, interest revenue is netted against interest expense; thereby reducing the embedded cost of debt, the WACC and the Company's allowed return. Because other revenue reduces the amount of revenue otherwise required from customers through rates, the full benefit of interest earned continues to be passed on to customers.

[3] The average debt under 2008 proposed is net of the unamortized deferred debt issue costs. The unamortized deferred debt issue costs are currently included in the calculation of rate base. The amortizations of deferred debt issue costs are currently included in the calculation of the WACC. As both the unamortized deferred debt issue costs and the amortization of deferred debt issue costs are related to the cost of capital, it is appropriate they both be included in the calculation of the WACC.

(b) It is likely that the actual cost of debt will vary from that set in test year due to changes in actual versus forecast interest rates and financing requirements. The significance of possible impact and whether the actual cost of debt increases or decreases will be dependent on future interest rates.

It is unlikely that there will be any significant changes in the Company's cost of preferred shares in the near term as there are currently no planned redemptions or issuance of preferred shares.

Changes in actual versus test year approved debt costs will impact Newfoundland Power's actual realized returns between test years; however, this is the case for virtually all costs in years subsequent to a test year.